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How Much House Can You Afford

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HOW MUCH HOUSE CAN YOU AFFORD?

Buying a home is the single largest purchase most consumers will ever make. Generally when looking for a home to buy, consumers find that they *want* a house that is larger and more expensive than they actually *need* to provide shelter. Deciding how much to spend on a home is very important and will have long lasting effects on financial security, family unity, and satisfaction.

When financing the purchase of a house with a mortgage, the principal, interest, real estate taxes, and hazard insurance (PITI) takes a large amount of a household's monthly income. Realistically these costs represent only a *portion* of total housing costs. Total housing expense includes PITI, plus costs for utilities, household operation, supplies, furnishings/equipment, and maintenance/repair. Estimating all possible housing expenses will help the homeowner plan a budget so that actual costs will be expected and will not limit the buyer's ability to meet other living expenses.

This publication is designed to help buyers during this decision-making process. Guidelines for determining housing affordability, ability to repay a mortgage, and total housing expense are provided, as well as a list of other factors that should be considered when making the decision to buy a house. It is much better to decide on a realistic price range for a house and stick to that decision, than to purchase a house and risk losing it later or being unable to keep it in good repair due to lack of funds.

Definitions of terms used in this publication:

PITI: Abbreviation for the following parts included in most mortgage payments: *principal* payment on the loan, *interest* on the loan, real estate *taxes*, and homeowner's hazard *insurance*. Other types of insurance, such as mortgage insurance, may be included in this category.

Mortgage Insurance: When a buyer makes a minimum down payment on a home, the lender often requires mortgage insurance. Private mortgage insurance insures the first 20 percent of a loan in case of default. The cost is added to the monthly PITI payment and is usually one-half of one percent of the mortgage loan for the first five years and one-quarter of one percent thereafter, or until the unpaid balance drops to 80 percent of the original loan. At that point it may be possible to cancel the insurance, but it is up to the borrower to request the cancellation.

Gross Income: The amount of income received before any deductions are taken out. Gross annual income is all income before deductions that is received over a 12-month period. The gross income received in any one-month period is gross monthly income.

Total Debt Load: Total of all debt for a household including mortgage payment, installment debt payments, credit card payments, car payments, medical debts, and education loans.

Installment Debt: A type of consumer debt in which the consumer pays the amount owed in equal payments, usually monthly.

Fixed Rate Mortgage: The interest rate charged for the mortgage remains the same for the entire term of the loan.

Adjustable Rate Mortgage: A borrower's interest rate can increase or decrease during the term of the loan. The mortgage specifies which index will be used to determine the change in interest rate and whether it will adjust on a monthly, quarterly, annual, or biannual basis. This mortgage is sometimes called a variable rate mortgage.

Balloon Clause: A clause in the mortgage that requires the last payment of the mortgage to be very large in comparison to the other monthly payments. Such a payment is called a balloon payment.

Fixed Expenses: Household expenses that are due on a regular basis and are equal each time they are paid, such as mortgage payment or loan payment.

Flexible Expenses: Household expenses that vary each time they are paid such as food or gasoline expenses.

Irregular Expenses: Household expenses that are not due monthly, but require payment at other intervals such as semi-annually or annually. Examples are repair bills or car insurance premiums.

Net Income: The amount of income received after non-voluntary deductions such as federal and state income taxes, FICA, and mandatory retirement deductions. Net income is sometimes called take-home pay, after-tax income, or disposable income. Net income may be stated in terms of annual or monthly time periods.

BUYING GUIDELINES

“Rule of thumb” guidelines such as purchasing a house that costs two times your gross annual income¹ may not be the best measure of how much home to buy. In addition to purchase price, the buyer must also consider the amount of money that is available for the down payment, closing costs, moving expenses, and deposits and connection fees for utilities. (Note: For detailed information on closing costs, see Extension publication EC 655 *Costs To Obtain a Home Loan*, from the Clemson University Cooperative Extension Service.)

Lenders use other guidelines to determine how much money they will lend a prospective homebuyer. These guidelines are based on the borrower’s ability to repay and vary among lenders. Lenders may allow 28-29 percent of the buyer’s gross monthly income for the mortgage payment (PITI). Lenders also consider total debt load (mortgage plus installment debt and credit card debt owed at the time of the mortgage loan application) when evaluating a mortgage application. Conventional lenders usually limit the total debt load to a maximum of 36 percent of gross monthly income. Under special homebuyer programs such as through the U. S. Department of Housing and Urban Development (HUD), Rural Development, and the South Carolina Housing Finance and Development Authority, a total debt load up to 41 percent may be considered². Some potential homebuyers may need to reduce current consumer debt in order to be considered for a home loan. (Note: See Extension publication HM 682 *Getting Out of Debt: A Self-Help Guide*, from the Clemson University Cooperative Extension Service.)

QUALIFYING FOR A HOME MORTGAGE

Ability to repay a loan is based not only on a buyer’s current financial circumstances, but also on his/her credit history (including record of promptness in paying bills and earnings history) and financial future. Lenders consider job security or the stability of earning power and income—such things as how long you have been employed, how long you have been with your current employer, whether you are a salaried or hourly employee, whether you have periodically received income increases, and other related factors. This helps lenders evaluate the risk they will have in lending you money, or the likelihood that you will be able to repay the money on time.

Homebuyers need to make their own risk evaluation before purchasing a house. If a poor decision is made and the homebuyer becomes unable to make payments on the home loan in the future, he/she risks damaging his/her credit record along with losing any money already paid for the down payment, closing costs, house payments, and improvements. Even if the homebuyer is still able to make the loan payments, a greatly reduced income affects other aspects of the household budget and adds stress to the household, which may result in marital conflicts, parent/child conflicts, or divorce.

Households with similar income and expenses may have different financial goals and other financial conditions that make one household more able than another to afford a given house. The following points should be considered when determining ability to repay a mortgage:

1. Income Stability and Job Security

Is there one income or more than one income in the household? How stable are both incomes? How secure is each job? What is the potential for increases in income or promotions? If an income earner lost his/her job, what is the potential for other employment?

2. Potential Expenses

Will you have a fixed-rate mortgage or an adjustable-rate mortgage? Adjustable-rate mortgages usually have a lower beginning interest rate, but rates may be increased in later years. If you are considering an adjustable-rate mortgage or a mortgage with a balloon clause, you must determine if your income will increase to meet the additional expense.

Will there be expenses for child care or additional transportation while one or more family members works?

Is the house energy-efficient? Lender's guidelines for the maximum amount of money they will lend may be exceeded by **2 percent** when the dwelling is energy-efficient. This is because an energy-efficient house will have lower heating and cooling costs, freeing up more money for a larger house payment or for other household expenses. Some lenders call this an **energy-efficient mortgage**.

What other expensive purchases are likely to be needed during the term of the mortgage, for example an automobile, furniture, educational expenses, or retirement?

- in 5 years?
- in 10 years?
- in 15 years?
- in 20 years?
- in 25 years?

3. Cash Reserves

How much money does the household have readily available for emergencies?

Could the household meet all expenses if one of the incomes was lost due to

- illness?
- unemployment?
- change in family status (such as birth of another child, divorce, expense of a family member in an education or training program)?
- need for an income earner to remain at home to care for an elderly or sick family member?

4. Debts

What other long-term debts such as education loans, car loans, or child support are outstanding? How much money is still owed? When will it be paid off?

Will additional credit card or installment debt such as for furniture be taken on after moving into the house? If so, the added debt may make it harder to meet mortgage payments.

5. Investment in Property

Lenders are even more inclined to grant a loan if the buyer will have 10-25 percent invested in the property after making the down-payment. Will you have this amount to invest?

Can you consider a mortgage shorter than 30 years if you plan to live in the house a long time?

It is important to analyze carefully your total financial situation before purchasing a house. First determine current household expenditures and financial condition. Then consider how events and changes that are likely to occur in the future could impact your financial situation.

BUDGETING FOR HOMEOWNERS

A realistic method to determine how much house you can afford is to develop a monthly budget based on your unique lifestyle and financial situation. First, determine all sources of household income and figure how much income is available each month (Work Sheet A will help determine gross monthly income). Second, estimate total living expenses. Consider fixed expenses such as mortgage and debt payments, flexible expenses such as food and utilities, and irregular expenses such as car insurance premiums and educational expenses (Work Sheet B will be helpful in determining total monthly living expenses).

Most lenders require a monthly mortgage payment that includes principal, interest, real estate taxes, and homeowner's insurance (PITI). However, most lenders **do not** include estimated monthly costs for utilities, housekeeping supplies, household operation costs, household furnishings and equipment, or maintenance and repair expenses when determining ability to repay a mortgage. *Total housing expense* is a better estimate to use for guidance when deciding the affordability of a particular house. Listed below are examples of items to include in the estimate of total housing expense.

Utilities/Fuels/Public Services

- electricity
- heating
- cooling
- water
- telephone
- sewer fees
- trash collection
- cable TV

Household Operation

- tools
- servicing heating/cooling system
- yard care equipment
- pest control
- lawn care

Housekeeping Supplies

- cleaners and soaps
- cleaning equipment
- paper goods

Household Furnishings and Equipment

- appliances
- furnishings
- household equipment
- linens
- window treatments

Maintenance/Upkeep/Repairs/Improvements

- repainting
- repairing electrical or plumbing systems
- roof and gutter maintenance
- heating/cooling system
- redecorating

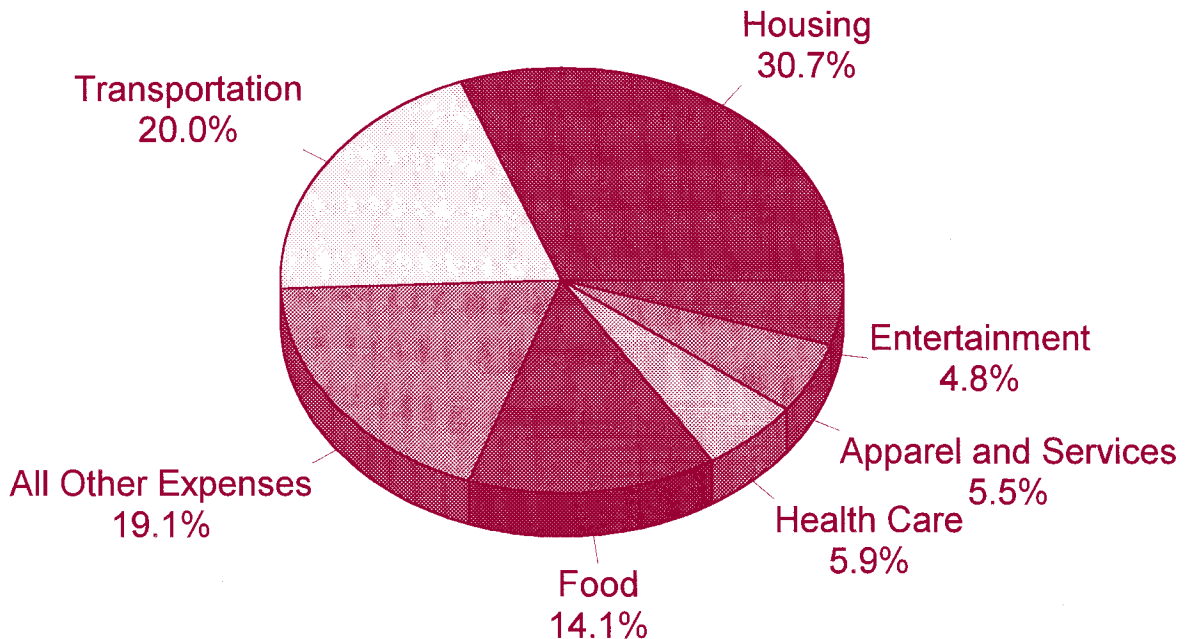
EVALUATING TOTAL HOUSING EXPENSE

Conventional lenders generally limit loan approval to two guidelines 1) PITI that is 29 percent of gross monthly income or less and 2) total debt load for mortgage and other consumer debt that is 36 percent of gross monthly income or less. How can potential homeowners determine an acceptable level for total housing expense? It is up to each buyer to determine a realistic portion of the household budget that is earmarked for housing.

YOU MAY FIND THE LENDER'S GUIDELINES ARE HIGHER THAN YOUR HOUSEHOLD CAN SAFELY HANDLE.

The following pie chart shows the relationship of housing expenses to all other household budget categories. The 1995 Consumer Expenditure Survey³ (the most recent data available) determined that the average consumer in the South spent 30.7 percent of gross income on housing expenses. This figure is the average calculated for all consumers who participated in the survey including both homeowners and renters, as well as those who already own their home and have no mortgage.

Household Budgets Southern Region, 1995



Individual categories as a percentage of annual gross income.

US Department of Labor, 1996

In the Consumer Expenditure Survey, the housing category includes the following percentages of gross income for housing costs: shelter, 16.0 percent; utilities/fuel/public services, 7.5 percent; household operations, 1.8 percent; housekeeping supplies, 1.3 percent; and household furnishings and equipment, 4.0 percent.

If a homeowner takes on a mortgage payment that is 29 percent of gross monthly income, total housing expense would be 43.6 percent of gross income when expenses for utilities, operations, supplies, and furnishings and equipment are added. An example is described in the case study on pages 7 - 8.

Housing-Expense-To-Income Ratio

It is also important to look at total housing expense in relation to *net* monthly income, because that is the amount of money a household actually has to spend after non-voluntary deductions such as income taxes and FICA. Some financial experts suggest that a **housing-expense-to-income ratio**⁴ will help homeowners determine an affordable amount to spend on housing.

The housing-expense-to-income ratio reflects the **total** cost of housing relative to a household's **net** income, and is calculated by the following formula, and expressed as a percentage:

$$\text{housing-expense-to-income ratio} = \frac{\text{total housing cost}}{\text{net monthly income}} (\times 100) = \text{ _____\% }$$

$$\text{For example: } \frac{\$687.40}{\$1964.00} (\times 100) = 35\%$$

Experts recommend that a housing-expense-to-income ratio in the range of 30-40 percent should be manageable for most people. Spending more than 40 percent of net income on housing may be unwise, unless this is a primary financial objective. One example might be a first-time homebuyer who is very motivated to own a home of his/her own and is willing to give up buying other things to make sure enough money is available for the house and related expenses. Deciding to spend more than 40 percent of net income for housing may make it very difficult to have enough money for other living expenses and may affect family financial stability. Family members need to discuss and agree on priorities for spending money.

Households with very high housing-expense-to-income ratios might develop problem loans. Inadequate financial planning and a lack of budgeting for unexpected housing expenses are often cited by housing experts as major factors in the high number of mortgage loans that are behind in payments, in default, or in foreclosure.

FIRST-TIME HOMEBUYER CASE STUDY

It is especially difficult for the first-time homebuyer to estimate housing expenses because of a lack of previous experience. The following case study provides a picture of a young, first-time homebuyer in the South in 1995.

Gayle House is 28 years old and has a 9-year-old son. She has a gross annual income of \$25,600 or \$2,133 gross income per month. Gayle has found a house that she likes with a purchase price of \$59,133, but she is unsure of her ability to afford the house at this time. Her monthly mortgage payments (PITI) would be \$619 or 29 percent of her gross monthly income. This is the maximum amount the lender would allow Gayle to borrow.

Gayle has rented an apartment for six years. Since most housing expenses have been included in the rent, Gayle does not know how much to budget for her total housing expenses. The county Extension agent reviewed the 1995 Consumer Expenditure Data and estimated Gayle's total housing expense. Table 1 shows the projected monthly housing budget for Gayle House and allows room for you to estimate your projected expenses on the right.

Gayle has also read that homeowners should set aside 1 to 3 percent of the market value of their home each year for maintenance and repairs⁵. Even though the house Gayle is considering has just been renovated, she knows that she will eventually have large repair bills. Thus, she needs to regularly set aside money (perhaps using a savings account) so funds will be available to cover expenses as the house ages. If Gayle budgets 2 percent of the \$59,133 value of this house for maintenance and repair, she will need to set aside \$99 a month (\$1,183 per year divided by 12 months). This represents 4.6 percent of her gross monthly income.

Table 1. Projected Monthly Housing Budget

		Gayle House	Your Calculations	
Gross annual income		\$25,600	_____	
Gross monthly income		2,133	_____	
Housing Expenses	Dollar Cost	% of Gross Monthly Income	Dollar Cost	% of Gross Monthly Income
Mortgage payment (PITI)	\$ 619	29.0%	\$ _____	____ %
Utilities/fuel/public services	160	7.5%	_____	6.8 %
Household operations	38	1.8%	_____	1.6 %
Housekeeping supplies	28	1.3%	_____	1.3 %
Furnishings and equipment	85	4.0%	_____	3.3 %
Maintenance and repair	99	4.6%	_____	4.6 %
Total:	\$ 1,029	48.2%	\$ _____	____ %

Since Gayle’s net monthly income is \$1,813 (85 percent of her gross monthly income), her housing expense to income ratio is 56.8 percent (\$1,029 divided by \$1,813). This figure greatly exceeds the recommended range of 30 to 40 percent.

Gayle also has a car payment of \$148 per month, making her total debt load \$767 (\$619 PITI plus \$148 car payment) or 36 percent of her gross monthly income. Even though her total debt load meets the lender’s limits, Gayle is concerned to see that her total housing costs (\$1,029) plus her automobile debt (\$148) means that she would be spending \$1,177 (55 percent) of her total gross income for just these expenses. This would only leave her about \$636 (35 percent) of her *net* income for all the family’s other needs and wants.

Considering her current lifestyle of eating out twice a week, visiting her parents in another state twice a year, the clothing requirements for her job and her son, and her goal of going back to college for a master’s degree in five years, Gayle has decided that purchasing this house would require a larger percentage of her budget than she is willing to spend.

As you have seen in Gayle’s situation, when deciding to purchase a home, the mortgage payment is only one factor. Gayle had to carefully consider family values, financial goals, income, lifestyle, and living expenses. Purchasing a home affects household budgets for a long time. It requires deep commitment to the decision by all household members, including children whose “wants” may burden the family financial situation.

Remember that Gayle does not have to give up her goal of homeownership. She could look for a smaller, less-expensive house to buy now and trade up to a larger home in the future or she could wait and save more money to put down on a house so that her mortgage payment would be lower. Potential homebuyers need to re-evaluate their financial situation periodically throughout their lives.

SUMMARY

Financial planning for affordable homeownership is more than just meeting the monthly house payment. It means planning to be able to afford to keep the house once you are in it. It means planning to meet homeownership expenses—small and large—as they occur. Finally, it means planning to have enough household income left for other household expenses without being in constant financial stress. Financial planning for affordable homeownership means you will be able to enjoy owning your own home!

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WORK SHEET A

DETERMINE GROSS MONTHLY INCOME

Amount

	Per Week		Bi-Weekly		Per Month		Per Year	
	gross	net	gross	net	gross	net	gross	net
Pay Check #1								
Pay Check #2								
Pay Check #3								
Pay Check #4								
Tips								
Commission								
Interest								
Dividends								
Gifts								
Annuities								
Social Security								
Retirement Benefits								
Child Support								
Alimony								
Public Assistance								
Veterans Benefits								
Income Tax Refunds								
Unemployment Compensation								
Rental Income								
Other								
TOTALS								

Total Gross Income from All Sources = \$_____ divided by 12 = \$_____ Gross Monthly Income

WORK SHEET B

MONTHLY LIVING EXPENSES

	Week 1	Week 2	Week 3	Week 4	Total for One Month	Total for One Year
Housing						
Mortgage payment (PITI) _____						
Mortgage insurance _____						
Utilities/fuels/public services _____						
Gas _____						
Electricity _____						
Water & sewer _____						
Telephone (basic service) _____						
(long distance) _____						
Trash collection _____						
Household operation _____						
Household supplies _____						
Furnishings & equipment _____						
Maintenance & repair _____						
Household help _____						
Homeowner assoc. dues _____						
Special assessments (sidewalks, landscaping, security) _____						
Food						
Groceries _____						
Groceries (non-food items) _____						
Meals eaten out/snacks _____						
School lunches _____						
Transportation						
Car payment _____						
Car payment _____						
Gasoline/oil _____						
Insurance _____						
Licenses/registration fees/taxes _____						
Maintenance & repairs _____						
Parking & tolls _____						
Rental, taxi, bus, car pool _____						
Clothing						
Purchases _____						
Cleaning & laundry _____						
Alterations & repairs _____						
Medical						
Insurance _____						
Drugs & medicine _____						
Hospital _____						
Doctor _____						
Dentist _____						
Eye Care _____						
Life/Disability Insurance _____						
Child Care/Nursery school/Elder care _____						
Personal						
Books, magazines, newspapers _____						
Tuition, course fees _____						
Barber, hairdresser _____						
Toiletries & cosmetics _____						
Postage, stationery _____						
Allowances _____						

MONTHLY LIVING EXPENSES

	Week 1	Week 2	Week 3	Week 4	Total for One Month	Total for One Year
Recreation and Entertainment						
Movies, plays, concerts, videos _____						
Cable television _____						
Hobbies/club dues _____						
Alcoholic beverages _____						
Tobacco _____						
Sporting goods/events _____						
Vacation _____						
Gifts and Contributions						
Donations/charities _____						
Birthdays _____						
Holidays _____						
All other _____						
Savings/Investments/Retirement _____						
Monthly Installments						
Department stores _____						
Bank charge cards _____						
Oil companies _____						
Loans _____						
Other _____						
Miscellaneous						
Alimony, support payments _____						
Union/professional dues _____						

Emergency Fund* _____						
Total Monthly Living Expenses					\$	

NOTES:

Keep a record of your current living expenses for a month. Look for ways to reduce your expenses and use the extra money to pay back your debts.

*It is very important to add an emergency fund category to your budget. It is impossible to predict all living expenses. An emergency fund provides a safety net for payment of unexpected expenses. Using credit on these occasions adds to overindebtedness.

Plan ahead for irregular expenses such as insurance, car licenses, and gifts. Save one-twelfth of the annual cost of these items each month. The money will be available when each bill is due.

Notes
